BILL # HB 2262 | **TITLE:** tax credit; research and development

SPONSOR: Huffman | **STATUS:** As Introduced

REQUESTED BY: House | **PREPARED BY:** Brian Cary

FISCAL ANALYSIS

Description

The bill would change the formula for the amount of research and development (R&D) tax credit (both corporate and individual) that can be claimed. The credit is based on the amount of the taxpayer's qualifying research expenses in Arizona. The current formula calculates the income tax credit as 20% of the first $2.5 million in qualifying expenses plus 11% of the amount exceeding $2.5 million. The bill would change the percentage of credited expenses above the $2.5 million threshold from 11% to 15%.

Estimated Impact

This bill would reduce corporate and individual income tax revenue to the General Fund based on the revised formula for calculating the tax credit. JLBC Staff, however, does not have access to the taxpayer data needed to derive an independent estimate of the impact. The Department of Revenue (DOR) maintains taxpayer records, and has devised an estimate of the bill's impact. DOR believes the fiscal impact of the bill would be a decrease in revenue of $(3.75) million to $(5) million in FY 2005 and $(7.5) million to $(10) million in FY 2006 and after.

While HB 2262 would lead to a direct reduction in corporate and individual tax liabilities, the bill would create a more favorable tax environment. As a result, the bill could generate additional economic activity that would lead to an offsetting increase in tax collections. This type of secondary, or dynamic impact, is difficult to estimate. The State of California has the most advanced state government level dynamic forecasting model. Based on their model, 18% of corporate tax reductions are offset by additional state revenue within 5 years.

The JLBC Staff has also acquired an econometric model for evaluating these economic impacts. Using this model, we will attempt to develop our own dynamic estimate. The modeling can be complex, so we are forwarding the fiscal note now in the interest of timeliness.

Analysis

Prior to tax year (TY) 2001, the R&D credit was limited to an annual maximum of $500,000 per taxpayer. The limit was increased to $1.5 million and $2.5 million, respectively, for tax years 2001 and 2002. Beginning with TY 2003, the annual limits on the credit were removed.

Based on DOR's analysis of taxpayer data from tax years 2000 and 2001, increasing the formula percentage from 11% to 15% for TY 2001 would have increased the R&D credit by $6.4 million, affecting 12 taxpayers. DOR also calculated the impact of the change using the TY 2000 database and estimated the credit would have increased by $31 million in that year, affecting 23 taxpayers. However, in TY 2000, there was only $6.3 million in additional liability that could have been offset by the change in the formula. Taxpayers could not take credits exceeding that amount in TY 2000, although they may carry forward the remaining tax credit. DOR's estimated annual revenue impact of $(7.5) million to $(10) million is based on improved economic growth and the expectation that it will continue through 2005. As profits increase, more tax liability is generated, providing more opportunities to claim credits that reduce tax payments. From a budget perspective, the fiscal impact would not occur until FY 2005 and FY 2006, respectively. Although tax liability is accrued on a calendar year basis, final tax payments and refunds are not issued until the following calendar year. The revenue loss in FY 2005 would be about one-half of the 2005 tax year estimate, or about $(3.75) million to $(5) million. As introduced, the bill does not set a date for the change to take effect. DOR's analysis assumes the effective date begins with tax year 2005.

Analysis (Cont'd)

There is one concern in directly translating historical tax data from 2000 and 2001 into a cost estimate for FY 2005 and later years. We do not know exactly when companies will elect to take the tax credits, especially when the long carry forward period for qualifying expenses (15 years) is taken into account.

Local Government Impact

Each year cities and towns receive an amount equal to 15% of income tax collections from two years prior. The reductions in corporate income tax collections would result in a reduction in local government distributions of $(563,000) to $(750,000) in FY 2007 and $(1.1) million to $(1.5) million in FY 2008 and later years.

2/2/04